

# Pension Administration and Capital Formation in Nigeria: The Challenges

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## Abstract

Pension issues affect both public and private sectors of any economy. The primary objective of pension scheme is to ensure the retiree's standard of living is smoothened after retirement to have normal living. It is also to provide retirement benefit to retirees, moreso, to provide uniform guidelines for administration and payment of benefit. The pension scheme could be funded by contribution(s) either by the employer or the employee or employer/employee contribution. Pension scheme provides retirement benefit including incentives to employees. But despite the vital role of pension scheme to sustain better living after retirement, the scheme is not reasonably sensitized. Particularly, the private sector employers are unable to provide retirement benefits to their retirees, this is traced to weak legitimate laws on pension. Besides earnings on pension funds are not accessible to retirees. In conclusion, effective pension administration and capital formation is capable of industrializing the Nigerian economy. Therefore, it is recommended that defined pension contribution should be encouraged with effective legal backing for maximum result to retirees and growth of the economy.

**Keywords:** Pension administration, Retiree, Retirement benefit, Pension contribution, Investment decision.

## 1. Introduction

The concept of pension has often been a subject of debate. This is primarily because pension issues are connected to many areas of economic and social policies, thus making their reform and administration a difficult task to undertake. Pension scheme was borne out of a desire to help households achieve an allocation of life resources by smoothing consumption over lifespan, thus providing payment that ensures that a retiree's standard of living is not much different from what obtained in the period immediately preceding his retirement. This is achieved by transferring resources from one's working life to post-retirement when income dries up (Modigliani and Muralidhar, 2004). Reischaver (1988) in Ugwoke and Ogoegbunam (2013) stated that the primary reasons for a state to provide a pension scheme is the belief that many citizens are myopic, thus lacking the information necessary to enable them accumulate adequate resources for retirement. Moreso, there exist an absence of developed insurance markets owing to informal deficiencies and capital markets that put annuities beyond the reach of the average man. Moreover, among the low income group, their lifetime incomes may be too low to cover minimally adequate consumption levels during their retirement as well as their working years.

These reasons necessitated government involvement in the provision of retirement benefits in the form of an occupational pension scheme. The purpose of such scheme is to provide employees regular and stable income after their retirement from service. By extension, it can be considered as an arrangement by an employer or a group of employers to provide pension and sometimes other benefits for their employees when they leave or retire. They also provide benefit to the employee's dependant if he dies. The pension scheme is usually funded by contributions either from just the employer or from both the employer and employee. The benefits of a good pension scheme are enormous, aside from providing retirement benefits, it also serves as an incentive to employees as well as aiding to attract and retain experienced staff (Clark, 2004). In pursuance of this, a Pension Reform Act was passed in Nigeria in 2004. Some of its objectives include to ensure that workers receive their retirement benefits as and when due; assist improvident individuals save in order to cater for their livelihood during old age; and to establish a uniform set of guidelines and standards for administration and payment of retirement benefits. To this end, this paper shall focus on the administration of this scheme and its contribution to capital formation. The outline of the paper is as follows: Section one covers the introduction, Section two discusses the conceptual and theoretical framework of pension administration and capital formation, Section three presents the research design and methodology. The empirical results of findings are discussed in Section four, while Section five concludes.

## 2. Conceptual and Theoretical Framework

### 2.1 Overview of the Pension Reform Act

Prior to 2004, when the pension reform act was passed in Nigeria, pension activities were regulated by three bodies namely: Securities and Exchange Commission (SEC), National Insurance Commission (NAICOM) and the Joint Tax Board (JTB). SEC was responsible for licensing fund managers, NAICOM licensed and regulated insurance companies in the country, while the JTB approved and monitored all private pension schemes with enabling powers from Schedule 3 of the Personal Income Tax Decree 104 of 1993 (Bassey, Etim and Asinya,

2010). Pension or gratuity granted to retirees was on the basis of final pay chargeable to the consolidated revenue fund of the federation. However, administration was poor as the schemes were characterized by delays and sometimes non-remission of benefits to beneficiaries across the public sector. Orifowomo (2006) asserts that insufficient monitoring of pension activities by the regulatory authorities coupled with clear legal and administrative sanctions for erring parties led to poor compliance by stakeholders. Furthermore, there were no provisions for individual retirement savings account nor periodic publishing of statement of accounts and returns. Likewise, employees were not at liberty to choose their pension fund administrators and were subsequently at the mercy of the fund managers.

The Pension Reform Act 2004 was enacted partly as a result of the failure of previous schemes to address the pension needs of Nigerians and partly as a result of the quest by stakeholders to evolve a scheme that would provide for both the public and private sector employees. It repealed the 1993 Nigerian Social Insurance Trust Fund Act. Under this scheme, both the employer and employee in the private and public sector contribute 7.5% each of their monthly emolument, while that of the military is 12.5% and 2.5% for the employer and employee respectively. The Act obliges the employer to deduct and remit contributions to the pension fund custodian not later than seven days after deduction. The pension fund custodian, in part, must notify the Pension Fund Administrator within 24 hours of receipt of such contribution. It also made provision for an apex regulating agency (PENCOM), responsible for monitoring and controlling the deduction, administration and custody of pension funds, thus, ensuring prompt payment to beneficiaries (Orifowomo, 2006; Bassey, Etim and Asinya 2010; and Ugwoke and Ogoegbunam 2013).

### **3. Sources of Funds**

Pension schemes can be funded on a contributory basis (where the funds are sourced from the employer and employee) or non-contributory basis (in which 100% contribution is from the employer). In the words of Ugwoke and Ogoegbunam (2013), a well-funded scheme helps to spread the cost of benefits evenly over time, thus eliminating the vagaries in economic fortunes. The funding of public pensions has often presented difficulties since after the harmonization of pension payments in 1997. Okpaise (2009) argued that beyond 1997, subsequent increases in pension funding – 150 percent in 1999, and 142 percent in 2000 – have only presented more difficulties in pension payments in most government establishments. However, the funding of private pension schemes appears more reliable than that of the government, though workers in the public sector enjoy more generous retirement benefits than their counterparts in the private sector. The first attempt at providing for private sector workers was through the establishment of the National Provident Fund (NPF) by the Federal Government in 1961 primarily as a compulsory saving scheme for private sector workers and those in non-pensionable employment.

### **4. Pension Administration in Nigeria**

The Pension Reform Act (PRA) 2004 provides for the establishment of a contributory pension scheme for any employment in the Federal Republic of Nigeria. It stipulates the payment of retirement benefit to employees to whom the scheme applies, which comprises every public sector employee and private sector employees in a firm with staff strength in excess of five employees. The Act also establishes the National Pension Commission (PENCOM), whose duties include: to regulate, supervise and ensure the effective administration of pension matters in Nigeria; to approve, license and supervise the administration of pension funds by appropriate pension administrators; and to establish standards, rules and issuance of guidelines for the management and investment of pension funds in Nigeria (PENCOM, 2004).

The Act further provides that pension funds would be administered and managed only by Pension Fund Administrators (PFAs) licensed under the Act. In their course of administration, the PFAs would: open retirement savings account for their client; invest and manage pension funds and assets in accordance with the provisions of the Act; maintain books of account relating to pension funds managed by it alongside providing regular information on investment strategy, returns and other performance indicators to the Commission and employees. However, the Act stipulates that pension funds and assets are to be held solely in custody for the PFA by an independent Pension Fund Custodian (PFC), whose responsibility includes the receipt of total contribution remitted by the employer within 24 hours, notify of PFA of same and retain the pension assets in safe custody on trust for the employee and beneficiaries of the retirement savings account (PENCOM, 2004; Sogunle, 2011). The PFC provides some control over the activities of the PFA and provides a hedge against unauthorized access or trading. On the contrary, they are prevented from utilizing any pension fund assets in its custody to meet its own financial challenges or that of a third party.

### **5. Pension and Capital Development**

According to Al-Faki (2006), the capital market is a “network of specialized financial institutions, series of mechanisms, processes and infrastructure that, in various ways, facilitate the bringing together of suppliers and

users of medium to long term capital for investment in socio-economic developmental projects". The capital market is divided into the primary and the secondary market. The primary market or the new issues market provides the avenue through which government and corporate bodies raise fresh funds through the issuance of securities which is subscribed to by the general public or as elected group of investors. The secondary market provides an avenue for sale and purchase of existing securities. Sule and Momoh (2009) stressed that secondary market activities have impacted more on Nigeria's per capita income by tending to grow stock market earnings through wealth than the primary market.

From a global perspective, pension assets have seen rapid growth over the past decades, although they suffered large losses during the financial crisis of 2007 – 2008. Meng and Pfau (2010) asserted that this growth is notably due to both structural and parametric pension reforms since the 1980s. Over the past decades, the trend of social security reform has been marked by a shift from unfunded schemes e.g. pay-as-you-go (PAYG) to funded schemes. As a result, pension fund assets have increased markedly across the world (BIS, 2007; OECD, 2009), thereby contributing intensively to capital development in such countries. As highlighted by Hu (2012), pension fund markets in Organization for Economic Cooperation and Development (OECD) have witnessed a noticeable increase in pension assets from 1980 to 2012. For example, United Kingdom (UK) pension assets were equivalent to US\$115.6 billion in 1980, accounting for 21.5% of Gross Domestic Product (GDP) but rose to US\$ 1.6trillion (or 73% of GDP) in 2011. The same trend applies in many other OECD countries (OECD 2011). In the Asia-Pacific region, pension assets have also contributed to capital significantly. A study of 10 selected Asia-Pacific Countries conducted by Hu (2012) indicates that pension assets increased from US\$ 369 billion in 2001 to US\$1.7 trillion in 2010, signifying a four-fold increase over ten years. This put the average annual growth rate of the region over the period at 19.1%. In an assessment of the contribution of pension assets to the GDP in these countries, Australia came first with 2010 pension assets accounting for 105% of GDP, followed by that of Malaysia and Singapore. Average pension assets to GDP ratio growth in the 10-country region over the 10-year period was 19.9% in 2001 and 29.9% in 2010.

Chan-Lau (2004) is of the view that pension reforms and administration which introduce elements of funding tend to have a positive impact on financial market development as they improve the functioning of financial markets, thus aiding capital formation. For instance, by managing uncertainty and controlling risk, the financial system has been strengthened by pension fund growth. However, Hu (2006) and Davis and Hu (2008) are of the view that institutional investors in pension funds are engaged in positive feedback trading or 'herding behaviour'. This implies that there is the strong incentive to follow alongside the market sentiment or movements regardless of whether such investment decisions are rational and consistent with economic fundamentals, thus potentially destabilizing equity markets. A quantitative impact of the effect of pension funds on capital formation may arise mainly from differences in behaviour from the personal sector. Pension funds in most cases hold a greater proportion of equities and bonds, moreso as they hold portfolios with long-term assets yielding the highest returns. They also have a comparative advantage in compensating for risk by pooling and diversifying across assets with imperfectly correlated returns – an advantage linked to lower transaction costs for large deals and their ability to invest in large indivisible assets such as property.

As empirical evidence in developed and developing countries suggests, poorly designed public pension schemes can distort life-cycle savings and work decisions, leading to dead weight losses, lower output level and a lower growth path of output (Holzmann, 2003). More importantly, the financing of publicly-mandated pension schemes can affect aggregate savings and capital development, both of which can affect economic growth. Holzmann (1997) provides empirical evidence that financial market development and economic growth are closely related, and evidence from Chile suggests that the most positive value of funded pensions is the increase in the efficient use of existing capital. Indeed, the accumulated assets of pension funds are a major source of aggregate savings and can easily run up to 100% of GDP and more, depending on the size of contributions allocated to the system. Bouldrin, Dolado, Jemeno, Peracchi, Breyer and Fernandez (1999) provide a list of four factors that must be put in consideration in administering pension funds to aid capital development. These are:

- (i) The cost of transition process,
- (ii) The level of administrative costs,
- (iii) The riskiness of financial markets and
- (iv) The implication for the poorest workers at the bottom of the income distribution.

Catalan et al (2000) seeks to identify whether there is a Granger-Causality relation between capital markets and contractual savings via pension funds. They use two capital market indicators, stock market capitalization and stock market value traded across 26 countries, of which six are developing countries. They show that contractual savings institutions like pension funds granger-cause capital market development. Moreover, the potential benefits of developing contractual savings sectors are stronger for developing countries than for developed countries. Meng and Pfau (2010) in their study look at the linkage between pension assets and capital market indicators across 32 countries. They find that, in general, pension assets have a positive impact on the stock market in terms of depth and liquidity. However, when the regressions are run by dividing the dataset into

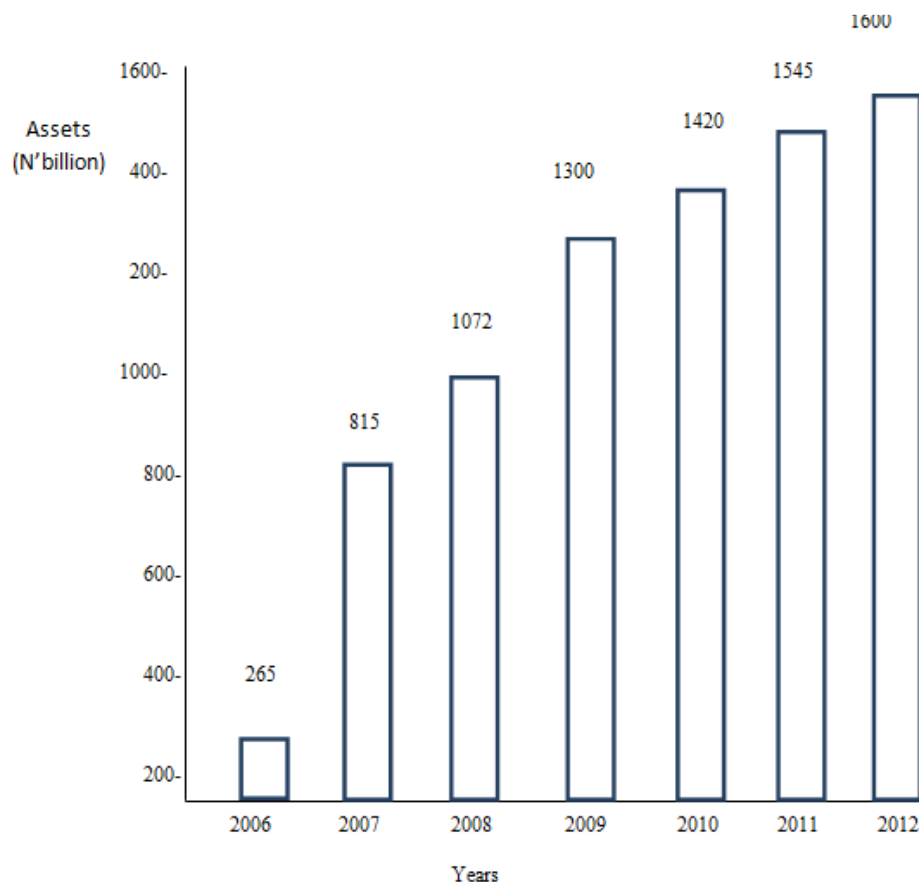
groups by level of financial development, the relationship is only statistically significant for the more developed countries.

With regard to bond markets, they believe that government have tried to attract foreign pension funds by modernizing the infrastructure of their public bond markets as well as facilitating private bond issuance. Evidently efficient capital formation arising from available funds such as pension funds raises output thus leading to greater productivity. The development of pension funds is also likely to trigger qualitative developments in financial markets, which may benefit growth through more efficient resource allocation. Such qualitative developments are in general subject to positive externalities. Apart from corporate governance, the effects of pension asset growth on qualitative development are not easily validated by means of direct econometric analysis but as part of the transmission to financial development and economic growth. In Organization for Economic, Co-operation and Development (OECD) countries, pension funds' need for hedging against shortfalls of assets against liabilities has led to the development of a number of recent financial innovations such as zero coupon bonds, index futures, and a longevity index (Faccio and Lasfer 2010).

### 6. The Nigerian Perspective

Pension system and administration in Nigeria has experienced some modest growth since the introduction of the defined contributory scheme to replace the pre-reformed defined benefit scheme. Pension assets have grown from N265 billion in 2006 to N1.6 trillion in 2012. Registered contributors also increased from 932 435 in 2006 to 5,888, 491 in 2012 (BGL, 2012). With less than 20% of the working population signed on to the scheme, Nigeria's pension industry portends great opportunity for industrial growth. At only \$11.2billion and only about 8% of the country's GDP, Nigeria's pension assets has the potential to grow to about \$47.32 billion in the next four years. However, industry competitiveness would be a prerequisite for the industry to realize its potential. To compete more favourably, pension managers would need to acquire appropriate technical and technological competence and maintain a lean structure for cost reduction purposes. Opportunities in the sector include capitalization of the already existing pension managers for better operation and mergers and acquisitions among industry players for economies of scale and technology sharing (Ogobuchi, Chukwuemeka and Uche, 2011; BGL, 2012).

Figure 1: Nigeria's Total Pension Assets (N' billion)



Source: PENCOTM

Based on the available information as published in the 2011 Retirement Savings Account (RSA) funds in Nigeria, the top pension managers in Nigeria include Stanbic IBTC Pensions Ltd, ARM Pension Managers, Crusader Sterling Pensions Ltd, Sigma Pensions Ltd and Leadway Pensure Ltd. However, financial information about several pension managers is not available. The contribution of these pension managers is as illustrated in the table below.

**Table 1: Top Pension Managers in Nigeria**

Pension Manager	Total Contribution (N million)	Total Contributors (N million)	Total Investment (N million)	Funds Unit Price (N)
Stanbic IBTC Pension	126,428.48	147,125.26	147,301.98	1.50
ARM pensions	36,943.96	39,914.92	41,402.06	1.57
Crusader Sterling Pension	25,397.74	24,432.36	28,270.52	1.54
Sigma Vaugh Pensions	62,006.92	64,664.04	63787	1.46
Leadway Pensure Pensions	39778.36	42,438.04	41,733.74	1.31

Source: RSA Funds Account (2011)

These pension managers have also undertaken differs investment of pension funds capable of aiding capital development. However, limitations on investment per issue on investment of any securities could affect competition and pricing. Below is the port-folio allocation of selected pension managers.

**Table 2: Port-Folio Allocation of Selected Pension Managers**

	Govt. Securities	Fixed Income	Money Market	Equities	Mutual Fund	Cash	Other Invests	Total
Stanbic IBTC	37.37	15.26	32.17	15.20	0.00	0.00	0.00	100
ARM Pensions	42.05	0.00	35.38	22.10	0.47	0.00	0.00	100
Crusader Sterling	53.15	0.00	34.44	11.49	0.00	0.34	0.58	100
Leadway Pensure	40.75	0.00	33.91	22.15	0.53	2.66	0.00	100
Pension Alliance	50.20	0.00	34.99	14.81	0.00	0.00	0.00	100
Premium Pensions	51.00	0.00	34.00	11.00	0.00	1.00	3.00	100
First Alliance	44.60	9.45	32.27	11.91	1.77	0.00	0.00	100

Source: BGL, 2012

## 7. The Challenges

A general challenge experienced in most developing countries is the need to make pension fund management a competitive business by lowering entry barriers and restrictions on investible assets. Low coverage of the pension scheme is being experienced in various countries as most private sector workers are captured in the informal sector and the low-income earners cannot afford appropriate retirement and old-age savings (BGL, 2012). There is also a challenge in the area of continued maintenance of appropriate level of investments and payments of retirement benefit as at when due. This could be difficult as some countries are still recovering from economic recession. Increasing pressure from regulations, investment strategies and governance makes the management of pension funds even more difficult.

In Nigeria, the low coverage of pension contributors to the working population suggests that the social statistics data that gives more population may be mis-leading. This poses a challenge to Nigerian pension managers. Lack of trust in the country's financial system does hinder the informal sector from joining in the scheme (Ogobuchi, Chukwuemeka, and Uche 2011).

A more pressuring issue too, is the high amount of unused cash within the system due to lack of investible assets. Like other developing countries, restriction on asset allocation can only be beneficial to the industry on the short run. Regulatory restriction and asset allocation continue to inhibit industry competitiveness. While the restriction has protected the industry from losses arising from the crash of the equity market, it also inhibits from benefiting from equity market boom. In addition, owing to the restriction of excessive foreign investment, the Nigerian pension sector may lose out on huge potential returns on investment in other emerging markets developmental projects with a possibility of reprisal investments in Nigeria's infrastructural project (Ogwumike, 2008; Ogobuchi, Chukwuemeka, and Uche 2011).

## 8. Conclusion

It is noted that pension administration and capital formation in Nigeria, if channelled into productive ventures is capable of transforming the economy into an industrialized economy.

## 9. Recommendations

This study provides the following policy recommendations

- (i) The defined contribution scheme should be encouraged, with effective legal backing and increased government responsibility to pension managers
- (ii) There is also increasing need for efficient risk management framework in investment strategies
- (iii) Diversification of pension funds into alternative asset classes to ensure much higher correlation to equities in a market sell-off.
- (iv) Avenues should be created for protection of invested funds.
- (v) There should be increased focus on investments in emerging market funds where economic growths are projected to be strong.
- (vi) Government should encourage savings and investment of pension funds in a bid to aid more capital development.
- (vii) Researchers are encouraged to research more into the topic.

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